

Q3 2020 Prepared Remarks

Denise Garcia, Investor Relations

Welcome to Upwork's discussion of its third quarter 2020 financial results. Leading the discussion today are Hayden Brown, Upwork's President and Chief Executive Officer, and Jeff McCombs, Upwork's Chief Financial Officer. Following management's prepared remarks, we will be happy to take your questions. But first, I'll review the safe harbor statement.

Safe Harbor Statement

During this call, we may make statements related to our business that are forward-looking statements under federal securities laws. These statements are not guarantees of future performance, but rather are subject to a variety of risks, uncertainties and assumptions. Our actual results could differ materially from expectations reflected in any forward-looking statements. In addition, any statements regarding the current and future impacts of the COVID-19 pandemic on our business and current and future impacts of actions we have taken in response to the COVID-19 pandemic are forward-looking statements and related to matters beyond our control and are changing rapidly. For a discussion of the material risks and other important factors that could affect our actual results, please refer to our SEC filings available on the SEC website and on our Investor Relations website as well as the risks and other important factors discussed in today's press release. Additional information will also be set forth in our Quarterly Report on Form 10-Q for the three months ended September 30, 2020 when filed. In addition, reference will be made to non-GAAP financial measures. Information regarding reconciliation of non-GAAP to GAAP measures can be found in the press release that was issued this afternoon on our Investor Relations website at investors.upwork.com.

As always, reported figures are rounded; unless otherwise noted, comparisons of the third quarter of 2020 are to the third quarter of 2019. All measures are GAAP unless cited as non-GAAP.

The prepared remarks corresponding to the information reviewed on today's conference call will also be available on our Investor Relations website shortly after the call has concluded.

Now I'll turn the call over to Hayden.

Hayden Brown, President and CEO

Thanks Denise and thank you all for joining today.

I'm pleased to report third quarter revenue of \$97 million, representing 24% year-over-year growth and exceeding the high end of our guidance range. Gross Services Volume (GSV) grew 23% year-over-year and accelerated quarter-over-quarter due to a continued secular shift toward remote and independent work, coupled with strong execution by our team against our growth strategy.

Our third quarter performance was fueled by both existing clients and new clients, who adopted Upwork in record numbers. At the start of the quarter, we recognized that some clients continued to face pandemic-related challenges, and we prepared for the possible impact on our business. Our stronger than expected third quarter was driven by our customers' accelerating adoption of Upwork, acknowledging the value we offer, regardless of their situation or condition.

The value we create is inherent in what we are: Upwork is the world's largest work marketplace, as measured by GSV, connecting businesses with independent talent. We enable trusted relationships between clients and freelancers that result in high-quality work outcomes, at a speed and with a value otherwise unachievable. Once clients realize what can be accomplished on Upwork, they proactively and strategically build a Virtual Talent Bench of freelancers with whom they work time and again, across a widening range of use cases. And, in turn, freelancers' earnings power on Upwork expands as they build a business best suited to their own needs. Thus, we are leading a shift to a new way of working.

Along those lines, I would like to read a quote from a recent article in the Harvard Business Review titled "Rethinking the On-Demand Workforce," which surveyed 700 U.S. business leaders on the topic. The authors observe:

"That companies are leveraging high-skills platforms in large numbers came as no surprise to us, because in recent years we've seen how they can increase labor force flexibility, accelerate time to market, and enable innovation. We were impressed, however, by the variety of engagements that companies are making with the platforms. They're seeking help with projects that are short- and long-term, tactical and strategic, specialized and general. What's more, 90% of the leaders we surveyed—C-suite and frontline—believe these platforms will be core to their ability to compete in the future."

As the pioneer in our space, we have been building capabilities and tools for a world now increasingly ready to use them. Our vision is to place independent talent at the heart of every business; everything we do is, and will continue to be, focused on powering our customers' progress.

With that backdrop, I'd like to discuss our third quarter performance, first through the lens of our ability to generate new business via client acquisition and then through the lens of our ability to generate new spend via existing client retention. After that, I'd like to highlight a couple of timely topics related to what we're doing to continue to make Upwork the single destination for every business to realize their full potential by working with independent talent.

Starting with new client acquisition, we maintained the elevated pace of new client registrations which appeared in the second quarter. This boost translated into meaningful GSV and revenue growth during the third quarter. In fact, we are seeing that cohorts of our clients acquired since the beginning of the second quarter are spending at higher levels than similarly aged cohorts from prior quarters. We expect the strong recent performance in new client acquisition will continue to positively impact our growth moving forward.

Nimble execution against our strategic growth initiatives has contributed to the growth we've seen in client acquisition. We strategically deployed messaging to resonate with businesses in search of remote work solutions, and simultaneously increased our investment in paid acquisition channels by 41% year-over-year, at equal or better cost per acquisition. We were able to do this by expanding our SEM presence on mobile, expanding our international reach and improving our bidding algorithm. As a result, both our US and international client registrations grew at record levels.

In addition, we continued to drive improvements in SEO performance as well as conversion optimization through the funnel. In Q3, we saw an 89% year-over-year increase in client registrations from the SEO channel as a result of a disciplined and systematic set of improvements we have been making over the

past year. We also launched a new content management system to develop and deploy our key SEO landing pages more effectively.

Now, let's shift gears to client retention, which was strong in the third quarter. Client spend retention was steady at 100% and the number of customers graduating to be core clients, which are our largest spenders, grew significantly faster in the third quarter than it had in previous quarters.

Our focus has been to make it as easy as possible for clients to work more deeply and broadly with the full array of talent on Upwork, and for talent to similarly expand their earning power on Upwork. We hear from clients again and again about the new potential they unlock for their businesses by building their own Virtual Talent Bench of team members on Upwork. Once a client works with a freelancer on Upwork, they consider that freelancer to be part of their extended team, perpetually available on their Upwork Virtual Talent Bench. The client may go back to that freelancer every month or once a year, but that connection doesn't typically end with the project. Our goal is to help clients unlock productivity gains by utilizing an ever deeper and wider Virtual Talent Bench. And the benefit to talent is similar: by building a roster of clients that they work with on a repeat basis, they spend less time winning new work, and more time doing the work they love, with clients that they have strong and trusted relationships with spanning many years.

I'd like to highlight a client making strides to develop their Virtual Talent Bench. One of our large technology clients recently transitioned all open employee requisitions to Upwork and decreased their time to hire 10x: from 80 days down to eight days. They were able to lower costs by more than 50% while achieving their growth goals. Based on the success of the program, this client is working to expand the program by 50 or more freelancers from Upwork by the end of the year. They have told us how extraordinary it has been to find people to do work that previously they only imagined they could have done by full-time employees. And the Upwork talent working with this client is able to leverage their skills and expertise while growing their own business.

We are working with some of our largest clients to unlock the full benefits they realize by building a Virtual Talent Bench on Upwork that integrates their Upwork and non-Upwork talent on our platform. Our Bring Your Own Talent (or "BYO") service, which grew 37% year-over-year in Q3, allows clients to centrally and seamlessly manage the entirety of their independent workforce program and projects on one platform, whether or not the talent was sourced via Upwork, and whether or not that talent is an independent contractor or employed through our employer-of-record service. Enterprise clients, in particular, have started to uncover the full value of this service, which gives them the visibility and controls they require for high scale workforce programs without sacrificing strong relationships with incredible, trusted talent for critical work.

Now, I'd like to drill down a bit on our enterprise customers, specifically as it related to our sales strategy.

We recently completed a comprehensive analysis of the economics of our sales efforts. The key finding was that the lifetime value of the customers on our Enterprise service plan are compelling, but that of the customers on our Business service plan, relative to the support costs, are less so. While Enterprise plan customers spend an average of \$1M per year, Business plan customers spend less, yet carry significant costs to support. We are confident that we can acquire and support the type of clients currently on our Business plan more efficiently through our self-service marketplace solutions - the Basic and Plus plans - thereby freeing up the Business plan-related sales and support resources for higher-return investment opportunities.

Consequently, we are strategically realigning our sales organization to target new accounts with greater than 250 employees, and new clients with fewer employees will be served via our self-service offerings. Our sales team is refocusing its energy on selling the Enterprise plan, targeting its capabilities against the right opportunities. As part of this process, we will reduce our sales team by approximately one-third, focused primarily on those who were selling the Business plan to smaller customers. We do not take such decisions lightly, but rather with full consideration of what is best for all of our stakeholders.

These actions do not change our near- or long-term growth expectations. In fact, this move sharpens our sales focus on our strategic priorities of getting more, bigger clients and enabling more spend per client. Our recent analyses, resulting in tighter account targeting criteria and a smaller, more fit-for-purpose team, strengthen our ability to grow the business faster by selling our Enterprise plan into truly large accounts that meet our criteria, enabling them to build a Virtual Talent Bench of high-quality freelancers to unleash their full business potential.

One recent example of an Enterprise customer building their Virtual Talent Bench on Upwork is Zendesk, an integrated customer support software company with more than 4,000 employees. Zendesk became a client in the second quarter, at first experimenting with how to uncover strategic value using talent found on our work marketplace. Now, their Virtual Talent Bench is extensive and growing, with teams across Zendesk using Upwork across seven categories from Accounting and Administrative Support to Engineering and Software Development.

Next, I'd like to highlight another way in which we are expanding our platform to more effectively serve our customers.

Last week, we announced the launch of Project Catalog™, a curated collection of pre-scoped projects easily purchased via an e-commerce click and buy experience. It provides a new way for clients and freelancers to work together on the Upwork platform and is part of an ongoing expansion of the Upwork experience. Project Catalog is in beta now, and it will launch to all customers in February of next year. We created Project Catalog based on feedback from freelancers and clients looking for expanded ways to engage on Upwork.

For clients, Project Catalog represents an easy way to quickly purchase some of the most popular services freelancers offer, from website development and graphic design to videos and digital marketing. For example, a client that wants to create an animated explainer video can search Project Catalog and quickly choose from a range of pre-packaged options. For new clients, Project Catalog represents an additional pathway to discovering the incredible array of work solutions offered by the world of talent on Upwork. For existing clients, Project Catalog can augment larger and more complex role-based work with smaller, well-defined tasks, such as adding voice over to a video project, logo design to a brand identity project, or copywriting to a website redesign project.

For our freelancers, Project Catalog is an opportunity to augment the businesses they've built on Upwork with a new way to market and sell the services they do time and again, thereby amplifying their earning power. The response from freelancers to the Project Catalog beta has been impressive, significantly exceeding our goals within the first few weeks. Long-time Upwork freelancers have told us how excited they are to create a new income stream by showcasing their top services, such as building responsive websites with WordPress, creating explainer videos or writing a series of blog posts.

In closing, I want to look to the future. This has been a challenging year for the world, and it's impossible to know what lies ahead. Despite the uncertainty, Upwork sees a future that is rich with possibility and opportunity for our clients and talent. We are committed to removing the constraints of established work norms in order to unlock our customers' true potential. Through the Upwork marketplace, our customers don't just find each other, they discover a transformational way of working. We know this firsthand at Upwork, where approximately two-thirds of all of our internal talent are freelancers from the Upwork marketplace. Our vision at Upwork is that independent talent works at the heart of every business. And I couldn't be more excited about our trajectory for helping more businesses discover the power of independent talent, making that vision a reality.

I'll now turn the call over to Jeff to discuss our financial results in more detail.

Jeff McCombs, Chief Financial Officer

Thanks Hayden.

I'm now one quarter in and have had the opportunity to dive into our business. A few things stand out. First, I'm impressed by the passion of the team and its focus on delivering on our mission. Second, as I suspected when I decided to join Upwork, the pandemic is driving material, structural changes in the way work is done. And third, we are well-positioned and have an amazing opportunity to support freelancers and clients in achieving their potential in this new world of work.

As I dive into the business, I am evaluating what metrics will be most helpful for the investment community in evaluating our performance and potential for value creation. Some of our current metrics, including client spend retention and core clients, are fairly lagging in nature and don't provide as much real-time insight into how the business is currently performing as we'd like. We are planning an analyst day in the first half of next year to provide a more in-depth look at the go-forward strategy, near-term priorities and potentially new metrics.

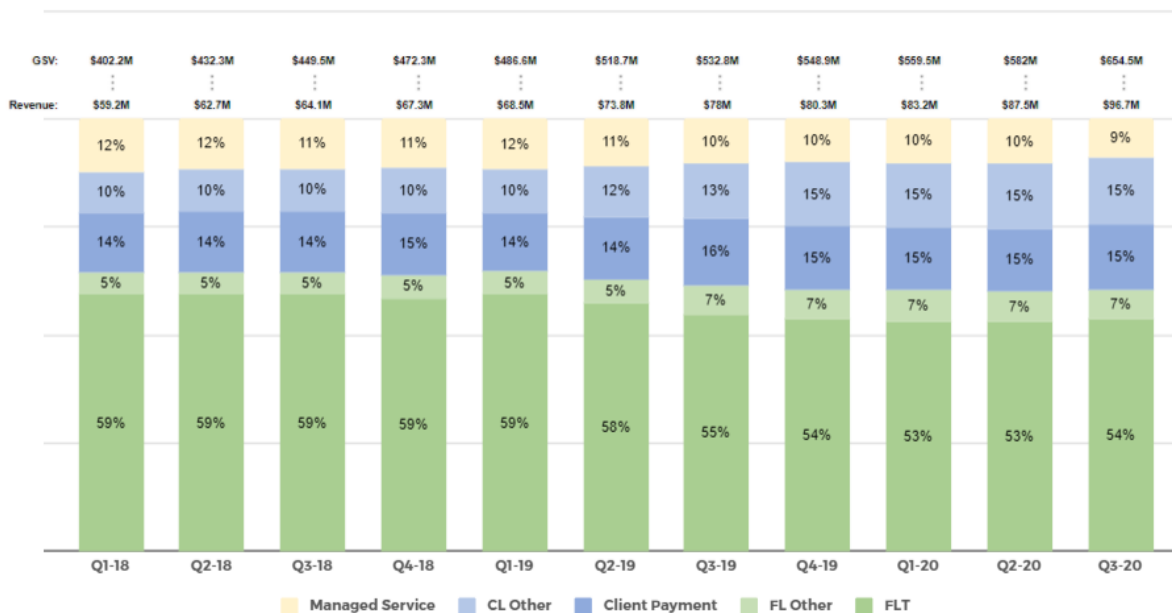
Now, let's look at the third quarter numbers.

GSV in the third quarter was \$655 million, a 23% year-over-year increase. Revenue in the third quarter was \$97 million, reflecting a 24% year-over-year increase, driven by marketplace revenue growth. Marketplace revenue was \$88 million, reflecting a year-over-year increase of 26%, driven by freelancer tiered service fee revenue, payments revenue which benefited from more foreign exchange fees due to growth in international revenue, and revenue from Connects, which are our virtual tokens for freelancers. Managed services revenue was \$9 million.

Core clients grew by approximately 5,600 to 139,000 at the end of the third quarter, with new core clients in the quarter growing 24% year-over-year. Client spend retention was 100%, and we expect the spending strength of existing clients in Q3 will help push this metric up in future quarters. As Hayden referenced, our retention performance in Q3 exceeded our own expectations for a couple of reasons. First, we anticipated that many of our small business customers would be negatively impacted by macroeconomic conditions in ways that would cause them to pull back spending on our platform. While this did happen to some of our clients, it was less than we had prepared for. Second, cohorts of clients we acquired in the past year performed well, bolstering GSV and revenue, even though they will not impact our client spend retention number this quarter.

Our overall take rate in the third quarter was 14.8%, and our marketplace take rate dropped slightly from 13.7% in Q2 to 13.6% in Q3. This decrease was almost entirely driven by an increase in deferred revenue resulting from more revenue being earned in the 20% and 10% tiers in Q3 than in Q2 due to strong client acquisition in Q3.

Components of Revenue



In Q3'20 certain incentive rebate revenue amounts were reclassified from Freelancer Other to Client Other. Accordingly, prior period revenue mix is represented in this chart, resulting in a 1 percentage point mix shift from FL Other to CL Other in Q1'20 and Q2'20.

Non-GAAP gross profit was \$70.4 million, or 73% of revenue.

Non-GAAP sales and marketing expenses were \$32.4 million, representing 33% of total revenue as compared to 32% in the third quarter of 2019. The increase was driven by investments to drive brand awareness, performance marketing, and sales.

Non-GAAP R&D expenses were \$18.3 million, representing 19% of total revenue, consistent with the third quarter of 2019.

Non-GAAP G&A expenses were \$14.3 million, representing 15% of total revenue as compared to 18% in the third quarter of 2019. We will continue to drive leverage in G&A as we scale for growth.

Transaction losses were \$0.7 million in the third quarter, representing approximately 1% of total revenue, at the low-end of our typical 1-2% range. Consistent with Q2, the pandemic and faster payouts have not increased transaction losses as much as we had anticipated.

Non-GAAP net income was \$5.0 million in the third quarter of 2020 compared to non-GAAP net income of \$1.1 million in the third quarter of 2019. Our basic and diluted non-GAAP net income per share was \$0.04 in the third quarter of 2020 as compared to a non-GAAP net income per share of \$0.01 in the third quarter of 2019. Adjusted EBITDA was \$6.7 million in the third quarter compared to adjusted EBITDA of \$2.0 million in the third quarter of 2019.

We are guiding fourth quarter revenue between \$96 million and \$98 million and expect year-over-year GSV growth to be in line with revenue growth. We remain bullish on our business opportunities and will continue funding growth initiatives while closely monitoring our performance to achieve our ROI thresholds. Looking at the investments we plan to make in Q4, we expect EBITDA margin to be in the low single digits. We will continue to manage costs with discipline while preserving our cash and maintaining our strong balance sheet, which included cash and marketable securities of over \$155 million at the end of the third quarter.

As we look to the future, while uncertainty in the overall environment remains from COVID, we are excited about where the business is headed. In terms of 2021, we are targeting revenue growth of 20% with an EBITDA margin in the low single digits. We plan to provide formal guidance on our next quarterly earnings call.

Thank you, and we will now take your questions.